

Internal Revenue Service

memorandum

CC:TL-N-1920-89

Brl:HFRogers

date: JAN 27 1989

to: District Counsel, Manhattan CC:MAN

from: Assistant Chief Counsel, Tax Litigation CC:TL

subject: [REDACTED]

This is in response to your request for technical advice dated [REDACTED].

ISSUES

1. Whether the marital deduction trust created by the will of [REDACTED] is entitled to share in the appreciation of the assets of the estate of [REDACTED] from the date of [REDACTED]'s death to the date of [REDACTED] death.
2033-0000

2. Whether the petitioner possessed a claim against the estate of [REDACTED] for delayed income pursuant to N.Y. Est. Powers & Trusts Law § 11-2.1(k) with respect to real property and shares of common stock of [REDACTED]

CONCLUSION

[REDACTED]'s estate should be increased by the amount of property she would have been entitled to if she filed an action to enforce distribution, plus interest thereon. The marital deduction trust was entitled to share in the appreciation of the assets of the estate of [REDACTED]. It is unlikely that we will prevail on the delayed income claim, but it should continue to be advanced.

FACTS

[REDACTED] died during [REDACTED]. He was the husband of [REDACTED], the decedent in the instant case. [REDACTED] died on [REDACTED]. [REDACTED] will designated [REDACTED] and [REDACTED] (his son) as co-executors. His will also provided for a marital and a nonmarital trust. [REDACTED] was to receive all income from both trusts during her life. Upon her death, she had power of appointment over the corpus of the marital trust. If she did not exercise this power, the corpus was to be held in trust for their lawful descendants. The principal of the nonmarital trust was also to be held in trust for the benefit of their descendants upon [REDACTED]'s death.

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The estate was comprised of four major assets: [redacted] percent of the common stock of [redacted] (subsequently known as [redacted]), [redacted] real property, [redacted] real property, and [redacted] percent of the common stock of [redacted] (subsequently known as [redacted], [redacted])

For estate tax purposes in [redacted]'s estate the stock of [redacted] was valued at \$[redacted]. Dividends were paid on the [redacted] stock as follows:

[redacted]

As income beneficiary, [redacted] was entitled to the above amounts. In early [redacted], the common stock of [redacted] was distributed to four trusts for the benefit of the descendants of [redacted] and [redacted]. In [redacted], a dividend of \$[redacted]/share was declared by [redacted]. In [redacted], [redacted] was liquidated and its assets were sold for \$[redacted]. As of the date of [redacted]'s death, [redacted]'s common stock had a value of approximately \$[redacted].

For estate tax purposes in [redacted]'s estate, the [redacted] property was valued at \$[redacted]. In [redacted], the [redacted] property was condemned by the [redacted] Litigation over the value of the land was settled in [redacted].

For estate tax purposes in [redacted]'s estate, the [redacted] was valued at \$[redacted]. On [redacted], the [redacted] tentatively designated the [redacted] as wetlands pursuant to the state [redacted] act. In [redacted], [redacted] acres of the property was finally classified as [redacted], and [redacted] acres as [redacted]. Thereafter, upon denial of the estate's application to fill in and develop the [redacted] portion of the property, the estate instituted suit against the state alleging that the denial constituted a taking, thereby entitling the estate to compensation. This action is still currently pending before the [redacted] state courts.

[redacted] died on [redacted]. The assets of [redacted]'s estate were distributed to the trusts in early [redacted]. Cash in the amount of \$[redacted] was distributed to [redacted]'s estate and the common stock of [redacted] was distributed to four trusts established for the benefit of the remaindermen of the nonmarital trust established under [redacted]'s will.

DISCUSSION

We believe the best argument in this case is that the court should examine the total facts and circumstances. Pursuant to [redacted]'s will, he wanted [redacted] percent of his estate to pass to his

wife undiminished by any federal or state death taxes. The distribution to her was considerably less than that. Further, [REDACTED]'s will reveals he had two testamentary desires: first, to provide for [REDACTED] and, second, to minimize his estate taxes.

Further, [REDACTED] presumably had an expectation that distributions would be made to the trusts within seven months from the time letters testamentary were granted. New York Est. Powers & Trusts § 11-1.5 states a person entitled to a disposition or distributive share may maintain an appropriate action for payment after the publication of notice to creditors or the expiration of seven months from the time letters are granted. As the Practice Commentary by Samuel Hoffman states "The fiduciary is under a legal obligation to make a maximum effort to put the estate in position to make distribution at the end of seven months (see, In re Drase's Estate, 1948, 81 N.Y.S.2d 648)."

It is clear that the law in New York is that executors have a duty to distribute estate funds as promptly as conditions permit. See In re Wright's Estate, 177 N.Y.S.2d 410 (1958), modified on other grounds, 187 N.Y.S.2d 306 (1959), aff'd, 165 N.E.2d 561 (1960); Application of Roman Catholic Church of St. Paul the Apostle, 493 N.Y.S.2d 967 (1985); Matter of Will of Usdan, 480 N.Y.S.2d 81 (1984). This is true also in the trust context. In In re Chalmers' Estate, 297 N.Y.S. 176 (1937), the court held that where the will directed that a copartnership be terminated and liquidated as soon after the partner's decease as business conditions, convenience and circumstances permitted, the executrix did not have power to exercise unusual authority in administering the estate so as to postpone indefinitely the setting up of the trust contemplated by the testator.

Because the estate was involved in ongoing litigation regarding the real property, it is probably reasonable for it to have remained open. However, it is unreasonable for it not to have made any distributions to the trusts since there is no evidence that all of the assets were subject to claims of [REDACTED]'s creditors or to administrative expenses. Furthermore, based on [REDACTED]'s apparent intent to provide for [REDACTED], the marital trust should have been funded first.

Further, only the [REDACTED] property was affected by events within seven months of [REDACTED]'s death since it was condemned in [REDACTED], the year of his death. Since [REDACTED]'s will allowed his executors to fund the trusts with cash or in kind, the trusts could presumably have been almost wholly funded within seven months after [REDACTED]'s death and the burden is on the executors to show good cause why it was not. New York Est. Powers & Trusts § 11-1.5(d).

Pursuant to I.R.C. § 2033, [REDACTED]'s gross estate must include the value of all property to the extent of her interest

therein at the time of her death. [REDACTED]'s estate should, therefore, include all property to which she was entitled seven months after the date of [REDACTED]'s death since she had the right to commence an action to effect distribution.

At the time of her death, [REDACTED] also had a claim against [REDACTED]'s estate for interest at the rate of [REDACTED] percent per annum commencing seven months from the time the letters testamentary were granted. (Since the delay in funding the trusts was presumptively unreasonable, we can argue interest should be at the legal rate during the period of unreasonable delay.) New York Est. Powers & Trusts § 11-1.5. For purposes of section 11-1.5, it is unimportant that [REDACTED] was one of the executors. See In re Crea's Estate, 318 N.Y.S.2d 133 (1971). Pursuant to state law, once her distributive share was paid, her estate could no longer institute a claim for interest. See Matter of La Fave's Estate, 456 N.Y.S.2d 964 (1982). However, since at the time of her death, [REDACTED] possessed that right, the interest should be included in her gross estate pursuant to section 2033. See also LGM In re: Limited Partnerships Used to Avoid Estate Taxes, TL-35 (January 22, 1988), which discusses some of the arguments to be advanced under section 2033.

Appreciation

Pursuant to section 2033, the Service increased [REDACTED]'s gross estate by over [REDACTED] dollars to reflect the marital trust's entitlement to share in the appreciation of the assets of [REDACTED]'s estate. [REDACTED]'s will gave his executors the power and sole discretion to satisfy the funding of the marital trust "wholly or partly in cash or in kind and to select the assets to be included therein, provided, however, that all such assets included shall be valued at the value thereof as finally determined for Federal estate tax purposes, and that the total value of such cash and/or property at the time of distribution to my said Trustees shall be at least equal to the amount of this bequest."

[REDACTED]'s estate is relying on New York Est. Powers & Trusts § 2-1.9 in arguing that the fiduciary has the duty to minimize the value of the assets distributed in kind to satisfy this bequest. Petitioner also argues that it was [REDACTED]'s intent to minimize the value of assets distributed to fund the marital trust since [REDACTED]'s will provides:

In selecting a valuation for the purposes of the Federal estate tax I direct my executors to select the date which will result in the

lower Federal estate tax on my estate regardless of the effect this selection may have on the amount of this bequest.

The second part of petitioner's argument is easily addressed. [REDACTED] left over [REDACTED] percent of his estate to [REDACTED]. She was entitled to all of the income from both trusts. It is apparent that [REDACTED]'s intent was to provide for [REDACTED]. Also, it is apparent that [REDACTED] intended to reduce the taxes owed on his own estate. In [REDACTED], the marital deduction was limited to the greater of \$[REDACTED] or one half of the decedent's adjusted gross estate. Therefore, [REDACTED] left [REDACTED] the maximum amount of property which qualified for the marital deduction. However, [REDACTED]'s income interest in the nonmarital trust was not based on tax considerations, but was established solely to provide for [REDACTED].

Further, [REDACTED]'s directions to his executors required them to select either his date of death or a date [REDACTED] months thereafter as the date upon which the value of his property was to be determined. See I.R.C. § 2032. Pursuant to the decedent's directions, this valuation date must be selected after examining which date will result in lower estate taxes for [REDACTED]'s estate despite any effect this selection may have on the amount of the marital trust bequest. This language does not show an intent to minimize the value of assets used to fund the marital trust, rather it shows that [REDACTED] desired the lowest value in order to reduce his own estate taxes. Further, New York Est. Powers & Trusts § 11-1.5 was in effect at the time of [REDACTED]'s death. Therefore, [REDACTED] would have had an expectation that the marital trust would be funded within seven months after the letters testamentary were granted. Funding the marital trust [REDACTED] years after [REDACTED]'s death would be contrary to his expectations.

Additionally, New York Est. Powers & Trusts § 2-1.9 does not help [REDACTED]'s estate's position. New York Est. Powers & Trusts 2-1.9 provides:

(b) Unless the instrument expressly provides otherwise:

(2) Where a will or a trust agreement authorizes the fiduciary to satisfy wholly or partly in kind a pecuniary disposition or transfer in trust of a pecuniary amount and the instrument requires the fiduciary to value the assets selected by the fiduciary for such distribution as of a date other

than the dates of their distribution, the assets selected by the fiduciary for that purpose, together with any cash distributed, shall have an aggregate value on the dates of their distribution amounting to no less than, and to the extent practicable no more than, the amount of such testamentary disposition or transfer in trust as stated in, or determined by the formula stated in, the instrument.

As the Practice Commentary by Patrick J. Rohan notes, section 2-1.9 was enacted in order to prevent estates from losing the marital deduction because of Rev. Proc. 64-19, 1964-1 C.B. 682. Rev. Proc. 64-19 denies estates a marital deduction if marital trusts can be funded with assets which had declined in value or which had been depreciated since being valued for estate tax purposes. Since [REDACTED]'s will states that assets are to be valued at their value for estate tax purposes, but the total at distribution must be at least equal to the amount of the bequest, Rev. Proc. 64-19 is not applicable in this case.

The practice commentary also states that "(t)he addition of the clause 'and to the extent practicable no more than' is prompted by the inadvisability of providing that the assets selected shall have a value 'equal to' the pecuniary disposition -- which might not always be possible, and perhaps by estate planning considerations (to preclude excessive enlargement of the estate of the surviving spouse, with its consequent estate tax implications)." Section 2-1.9 must be read in conjunction with the rest of the state law. As previously discussed, section 11-1.5 demonstrates that the distribution should have been made within seven months from the time the letters testamentary were granted.

Although Estate of Goutmanovitch, 432 N.Y.S.2d 768 (1980), is relied upon by the petitioner in support of its allegation that the marital trust is not required to share in appreciation, it can be read to support Service position. As the court stated, "(t)he intention of the testator is always the primary concern." Id. at 775. We have previously pointed out that [REDACTED]'s primary intent was to assure that provision was made for [REDACTED]. Although he established a marital trust in the format and the amount required by section 2056 in order to assure that his estate would pay the minimum estate tax possible, he also made [REDACTED] the income beneficiary of the nonmarital trust which was not required for federal estate tax purposes. In the instant case, we do not have a will provision allowing the executors to make distributions without any obligation that they

be proportionate as was the case in Estate of Goutmanovich. Also, in Estate of Goutmanovich, the major portion of the distributions were made within the seven month administrative period and the widow was trying to share in appreciation which occurred during that seven month period. Therefore, the instant case is factually much better for the Service.

Estate of Guterman, 476 N.Y.S.2d 1006 (1984), also supports the Service's position. In that case, the court held New York Est. Powers & Trusts § 2-1.9 was unnecessary to protect a hybrid clause such as that at issue herein where the marital bequest will always be funded with assets having a value equal to the amount of the pecuniary bequest allowed as a marital deduction. The court determined that application of section 2-1.9 to a hybrid legacy would convert it into a true worth pecuniary bequest nullifying the authorization on the bequest having no "ceiling." Id. at 1008. See also In re Nelson, 524 N.Y.S.2d 120 (1988).

In Estate of Goutmanovich and Estate of Guterman, the executors could use the lower of estate tax or date of distribution values to fund the marital legacy. This hybrid type of legacy is characterized as having a "floor" but no "ceiling." 476 N.Y.S.2d at 1008. This floor under the legacy is meant to ensure that the surviving spouse in no event receives less than the amount of the marital deduction, but avoids a "ceiling" or direction to pay a precise amount, in an effort to permit the distribution of appreciated assets without the realization of gain. 432 N.Y.S.2d at 774. In the instant case, [REDACTED] will provides a floor but no ceiling since the assets must be valued at their value for purposes of [REDACTED]'s estate tax, and the distribution "shall be at least equal to that amount."

In accord with Estate of Guterman, therefore, section 2-1.9 should not be applied in this case since it would convert the legacy to a pecuniary bequest for a set dollar amount. It should be noted that if there had been a pecuniary bequest, a set dollar amount would have been subject to the trust as of the date of death of the testator even though there is an intervening period of administration, and the income beneficiary would be entitled to income thereon. New York Est. Powers & Trusts § 11-2.1(c)(1).

Also, if section 2-1.9 is not applicable, the former common law of New York which it overruled is applicable. As discussed in Estate of Goutmanovich, 432 N.Y.S.2d at 773, this common law requires the fiduciary to act impartially as between beneficiaries and precludes him from distributing unappreciated assets to the spouse and appreciated assets to the other

beneficiaries. This duty of impartiality would presumably also prevent the executors from distributing cash to the spouse and allocating any gains or appreciated assets to the remaining beneficiaries.

Delayed income

Presumably, New York Est. Powers & Trusts § 11-2.1(k) is a statutory embodiment of the common law principle that the trustee is under a duty to an income beneficiary to sell unproductive property within a reasonable time. See Restatement (Second) of Trusts § 240. If such a sale is not immediately made, the proceeds of the sale should be apportioned between the income beneficiary and the remaindermen. See Restatement § 241.

Section 11-2.1(k) discusses underproductive property. The version in effect at the time of [REDACTED]'s death treats as delayed income to which the income beneficiary is entitled "a portion of the net proceeds of any transaction with respect to any principal which consists of property...which has not produced an average net income of one per cent per annum of its inventory value for more than a year..." Pursuant to section 11-2.1(k), the examiner included \$[REDACTED] in delayed income in [REDACTED]'s estate. Apparently there is no dispute about including a portion of the condemnation proceeds from the [REDACTED] property in [REDACTED]'s estate. The only dispute is over the income received on liquidation of [REDACTED].

The main point in dispute under this version of section 11-2.1(k) is whether this average net income for more than a year is an average over the time the property is held (hereinafter referred to as the averaging rule) or whether it refers to a right to delayed income for each and every year in which the property fails to produce the appropriate income (hereinafter referred to as the each year rule).

We agree with the examiner that the right to delayed income accrues for each and every year in which the property fails to produce income of one percent of its inventory value. However, we believe the inventory value used is incorrect. New York Est. Powers & Trusts § 11-2.1(o)(4) defines inventory value as the cost of property purchased by the trustee and the market value of other property at the time it was made subject to the trust. Since we are arguing the common stock should have been made subject to one of the trusts within the seven month administrative period, that would be the proper time to look at the market value. New York Est. Powers & Trusts § 11-2.1(k) is based on the Uniform Principal and Income Act (1962 Act) which includes the above definitions, as well as stating that in the case of a testamentary trust, the trustee may use any value finally determined for the purposes of an estate or inheritance

tax. We, therefore, view the applicable inventory value in this case to be \$[REDACTED] the value of the stock of [REDACTED] in [REDACTED]'s estate.

You requested clarification of the grounds for the each year rule. The background file for LTR 8208010 has been destroyed. However, the letter ruling refers to its authority. The letter ruling relies on the Third Report of the Temporary State Commission on the Modernization, Revision and Simplification of the Law of Estates, Document #19 at pp. 1039 and 1046. This document indicates that the right to receive delayed income arises when the property fails to produce income equal to at least one percent of its inventory value in each year. The letter ruling further cites to Matter of Grove, N.Y.L.J., May 8, 1981 (Surr. Ct. N.Y. Co.), where the court stated that "(t)he statute clearly sets out the situation when the statute becomes operable when the property...has not produced an average net income of one per cent per annum of its inventory value for more than a year." The letter ruling also refers to The Uniform Principal and Income Act: A Plea for Uniformity, Trusts and Estates (September 1970). This article states that if a property produces just under one percent during any period prior to sale, the income beneficiary would receive the equivalent of four percent on that property per year for the period it was underproductive.

Also, although the petitioner points out that the statute refers to average net income in support of its position, this argument ignores the fact that "for more than a year" is also in the clause, and that this phrase supports the Service's position.

In 1987, New York Est. Powers & Trust § 11-2.1(k) was revised. The revision applies to proceeds received during any period as to which the fiduciary's account had not been settled whether the proceeds were received prior to or after the effective date. Therefore, this revision would be applicable to the instant case since [REDACTED] was liquidated in [REDACTED] and [REDACTED]'s estate was still open on the effective date.

Revised section 11-2.1(k) states, in pertinent part:

(1) Except as otherwise provided in this paragraph (k), a portion of the net proceeds of a sale by a fiduciary as defined in subparagraph three of paragraph (A) of section 11-1.1 of any principal property of an estate or trust, other than securities listed on a national securities exchange or traded in over the counter, held for more than a year which has not

produced over the period held an average net income of one per cent per annum of its inventory value (including as income the value of any beneficial use of the property by any income beneficiary), shall be allocated to income as delayed income, as provided in this paragraph (k).

There are two pertinent changes. "Any transaction" had been changed to "a sale." Revised section 11-2.1(k) clearly sets out that an averaging rule is applicable.

The estate argues that "any transaction" does not include a liquidation. We agree with you that Will of Grove, 447 N.Y.S.2d 721 (1st Dept. 1982), determines that the "any transaction" language covers liquidations. An even stronger argument may be made that "a sale" refers to a corporate liquidation. In [REDACTED], the assets of [REDACTED] were sold for \$[REDACTED]. This would clearly be "a sale". Further, the legal definition of liquidation of a corporation references that the assets are converted to money. Ballentine's Law Dictionary 743 (3d ed. 1969). However, revised section 11-2.1(k) states the one percent test involves averaging the annual income received over the period the property is held. We agree with you that the strongest argument to be made for the Service's position is based on the legislative history. This history states "(T)he changes are not intended to suggest that an income beneficiary would lose any cause of action the beneficiary may have held should an interested fiduciary delay the sale of underproductive property until distribution solely to avoid payment of delayed income to the income beneficiary where the fiduciary is the remainderman."

[REDACTED] was on [REDACTED]'s board of directors. [REDACTED] (the son), one of the remaindermen, was chairman of the Board. The husband of another remainderman was president of [REDACTED]. Therefore, an argument can be advanced based on the legislative history. Although we agree that our position is weakened by reason of [REDACTED] being one of the directors, we believe the overall facts support the collusive intent of [REDACTED] and the remaindermen to reduce her estate. Such efforts, in contravention of [REDACTED]'s and [REDACTED]'s (the son) duties as executors, should be futile.

(b)(5)(AWP) [REDACTED]. However, we view the entire circumstances of this case as evidencing an intent on the part of [REDACTED] and the remaindermen to try to evade estate taxes.

Despite the state statute requiring speedy distribution, the trusts established under [REDACTED]'s will were not funded until [REDACTED] after his death. Despite the provision in

██████s will that the marital trust be funded with an amount sufficient for ██████ to receive, in total, ██████ percent of ██████s adjusted gross estate, the marital trust was funded with considerably less than fifty percent (at the date of distribution) of the value of ██████'s estate. If section 2-1.9 is inapplicable, as we believe, the executors had a duty of impartiality to fund these trusts so each could share in the appreciation of assets.

Apparently the estate also considers the value of the ██████ stock on the date of ██████s death to be the applicable inventory value. The dividends paid up until the date of her death did not average one percent of such inventory value over the period the stock was held. After ██████s death, a large dividend was paid which caused the income produced by the stock to exceed this one percent value.

We agree with your decision to develop facts in an attempt to demonstrate that the sale of ██████ was deliberately delayed, and the dividends were allowed to accumulate, to avoid payment to ██████, the income beneficiary. As the case law under New York Est. Powers & Trusts § 11-1.5 demonstrates, it is not fatal to a cause of action for interest on delayed distributions that the beneficiary seeking such interest is also one of the executors. See In re Crea's Estate, 318 N.Y.S.2d 133 (1971). Similarly, we do not view it as fatal to this argument that ██████ was a co-executrix and a director.

(b)(5)(AWP)

If you do choose to argue the delayed income issue, we believe it would be advisable to make sure the record reflects that the amount in contention under the appreciation issue will be increased if we do not prevail on the delayed income issue so there can be no question for appeal purposes about the Service attempting to include twice the same amount of money. It has also come to our attention that the remaindermen have filed petitions in Tax Court on many of the same issues present in the instant case. We believe it may be appropriate to consolidate all of these cases so the Tax Court is forced to find that the appreciation went to either ██████s estate or to the remaindermen. Again, we are leaving the final determination regarding consolidation to your discretion.

- 12 -

If you have any further questions, please contact Helen F. Rogers of this office at FTS 566-3442.

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